Real Economy

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Governance

On the brink... The dire straits of the ruling coalition have been no secret for quite some time. This fall has been expected to turn out a torrid political season (see our predictions in MEGA no.4). And indeed, after a relatively calm August, abounding in routine bellicose political declarations, the thunder stroke. The raider attacks against several Moldovan banks, including the biggest "Moldova Agroindbank", made a mockery of Moldova's efforts at justice and economic reforms and, ultimately, of the country's European aspirations. Behind the splendid facade of "success story of Eastern Europe" transpired the same old brutal reality of Moldovan political and business life. Indeed, in a country where property of middle and big business (if this is not 'court' business) is not protected, what should an 'average Joe' expect? In short what these latest events mean?

Firstly, in Moldova power mostly lies not with public institutions, but with obscure special interests which have undermined and abused these institutions (see MEGA no.4). This does not bode well for the public trust in public institutions (which is already at historical lows) and ultimately in Moldovan state. At the end of the day, it may lead to emergence of a fully-fledged mafia-like regime in Moldova.

Secondly, Moldova is a country of multiple realities. The one reality boasts startling image in eyes of European institutions and Western partners, negotiates 'with great success' visa-free regime and DCFTA with the EU, elaborates myriads of development strategies and documents, enjoys exceptional economic growth, carries out justice and other numerous reforms, etc. The other reality is one of poverty, rising inequality, corrupt and manipulated justice system, fleeing population, etc. Guess which reality will finally prevail and how many citizens will have to evade this 'asylum'?

Thirdly, in a surrealistic fashion Moldova sometimes appears to be back in '90s. Thus, back are divisive historical and linguistic debates as well as back are the 'Wild West'-like raider attacks heralding a new redistribution of assets. Is the former used to ease the latter?

Last but not least, to paraphrase Vladimir Lenin, of all the reforms the justice reform is the most important one. Indeed, without proper justice system you cannot ensure protection of property, respect for contracts, loyal competition, proper delivery of public services and so forth. To put it bluntly, without justice reform the economic and social modernization of Moldova and its European integration are no more than pipe-dreams.

With all the institutional and political paralysis accompanied by special interests' marauding of Moldova's economy, the ruling coalition is clearly

In this issue:
- ***Raider attacks: what made them possible?***
- ***Has Moldova achieved a healthy growth?***
- ***Unevenly spread economic recovery;***
- ***Rising inflation and new challenges for the central bank;***

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REAL ECONOMY is a monthly economic review tracking the most important policy and economic evolutions. Its readers are policymakers, CEOs of domestic and international companies and banks, representatives of the international institutions and foreign embassies, political parties and economic journalists.

Used acronyms and abbreviations:
y-o-y - year on year; q-o-q - quarter on quarter; Q4'07 – fourth quarter 2007; Jan'09 – January 2009; NBS – National Bureau of Statistics; NEA – National Employment Agency; NBM – National Bank of Moldova; EG – Expert-Grup; MDL – Moldovan leu (national currency); p.p. – percentage points;

EXPERT-GRUP is a Moldovan policy think-tank whose mission is to create a working environment in which free and non-trivial thinking thrives in order for the institution to be a leading source of unbiased economic analysis and to effectively advocate for innovative ideas and solutions to the economic problems that Moldova encounters along its path of economic transformation, societal development and European integration.

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on the brink of collapse. Without false politeness, few would regret if it passes away. But then, where would the country go?

Business Climate

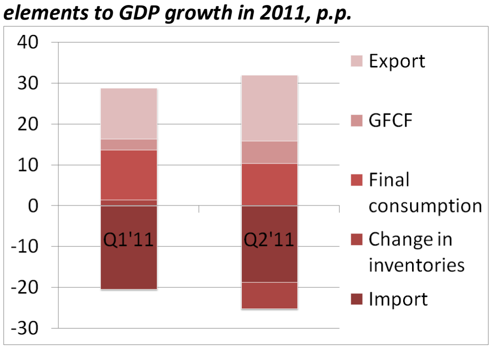
The recent raider attacks on several financial institutions have seriously dented the attractiveness of Moldovan economy. In an attempt to bring the situation under control on August 24, the Government issued a decision to adopt appropriate legal amendments that would prevent illicit practices on the securities market. The first normative act to come under consideration was the Law regarding the Financial Institutions[1]. According to the new provisions of this law as of August 27, 2011 NBM is entitled to control and approve transactions performed by the residents of off-shore zones / countries regardless of the share representing the object of the deal. Earlier provisions of the law did not allow the Central Bank to interfere in transactions with the residents of off-shore zones or countries; the only limitation in that particular case was the share size. Coordinated amendments were made to the Law on Securities' Market[2]. Under the new provisions the transfer of bank's shares will be registered only after the NBM permission is submitted. Corresponding amendments were also made to several other normative acts regulating the judiciary aspects of the issue. More specifically, the Moldovan court that examines the acknowledgement request of the foreign court should notify several official institutions in Moldova (including the NBM and Ministry of Justice).

While the above mentioned amendments are certainly welcome, a comprehensive revision of the system ensuring a secure transfer of securities is absolutely necessary. This involves amendments to the law on joint stock companies, but also to the Penal Code and Administrative Code. Should the Government fail to fix the wall guarding the property rights, Moldova's position in the international business rankings might drop down to an all time low.

GDP

On the first sight the Moldovan economy is flourishing. Not only we have had a high economic growth in Q2'11, but, more important, it looks like a healthy growth. Certainly, final consumption is still the most important growth determinant; but we witnessed an impressive rise in gross fixed capital formation (GFCF), inspiring an overdose of optimism. Additionally, exports advanced more rapidly than imports, a truly remarkable success for our country (Chart 1). On the production side, GVA rose faster than taxes on goods and imports. This seems to be a promising development and the Ministry of Economy is going to update its macroeconomic forecast, with up to up to 6-7% economic growth, much closer to the Expert-Grup earlier estimates (see MEGA no.4).

Chart 1. Contribution of expenditure elements to GDP growth in 2011, p.p.



Source: NBS;

However, it is much easier to recover, even at a high rate, than to keep a healthy growth in the long-term. In this respect Moldovan economy is still fragile, with serious weaknesses and challenges lurking in the shadows. Firstly, as long as internal demand grows faster than domestic production, the inflationary growth will impede the proportional improvement of the population welfare. Moreover, apparently the potential increase in

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[1] *Law regarding the Financial Institutions Nr. 550-XIII, 21 July 1995*
[2] *Law on Securities' Market Nr. 199-XIV, 18 November 1998*

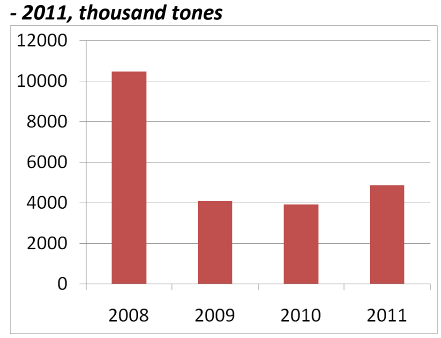
domestic production is limited due to almost full utilisation of input factors, including labour force as suggested by relatively low unemployment rate. Secondly, it is a jobless growth, with individuals still looking for opportunities abroad, while national economy is unable to provide well-paid jobs. The strong rise in investments might level out as soon as 'fiscal paradise' comes to an end. There are also significant external risks due to the yet uncertain situation in the global economy. Though not immediately, these may affect Moldova in terms of exports, remittances and FDI, with significant consequences on the economic growth.

Real Sector

While positive developments in agricultural output have gathered steam since the beginning of the year, the GVA growth in the sector flagged as input prices increased. Overall, the sector posted a 3.9% growth in the first half. Just like in the previous months the performance among the subsectors varies widely and growth is explained solely by the 8.7% growth in the output of beef and poultry (meat). This positive trend was slightly offset by the dip in eggs production. Although the aggregate amount of eggs produced is only 2% lower y-o-y, the output by corporate farms diminished by as much as 17.7%. As the imports of eggs rose, the local producers were forced to reduce the number of egg laying chickens by 15%. An additional explanation might be the increased price of fodder and other input costs that are not fully recovered by the egg products. Regardless the reason, this negative trend could aggravate even further once the legal provisions regarding the compulsory egg stamping will come in force starting with 2012.

The industrial sector is riding the recovery wave with a remarkable growth of 9.1%. Looking at the statistical breakdown it becomes obvious that nearly all industrial subsectors posted a positive evolution. The most striking was the performance of the quarrying and mining subsector, with a whooping growth of 20.6%. The manufacturing industry is also on the rise. The most dynamic growth was registered by the following subsectors: car and equipment manufacturing with 58%; medical equipment manufacturing 48%; furniture manufacturing and over industrial activities 46%. Obviously, the first half of the year marked the return of performance indicators left long behind in the pre-crisis times. The only field that is traditionally holding back the aggregate growth of the industrial sector is the energy subsector. During H1'11 the registered output went downhill by additional 3.3% (for more details see MEGA nr. 4).

Chart 2. Goods transported January-July 2008 - 2011, thousand tones



Source: NBS;

While the strong economic recovery and exports' growth generate expectations for a proportional rebound in transportation sector, this has not been the case so far. Despite the 24% increase in the amount of goods transported during the first 7 months of 2011 y-o-y, the current performance is far from pre-crisis level, accounting for merely 46% of the amount transported during the same period of 2008 (Chart 2). This troublesome recovery is explained by the fact that since Q4’2008 local businesses have increasingly contracted transportation services from foreign companies, as data from BoP indicate (see the Expert-Grup Short Analytic Note #39). Thus, from a net exporter of transportation services Moldova turned into a net importer after the economic crisis.

HOUSEHOLDS

Chart 3. Change in employment by economic sector in Q2'07 - Q2'11, Q2'07=100%

Source: NBS;

Positive labour market outlook for 2011 held true only partly. Indeed, unemployment rate dropped: both unemployment based on ILO methodology (6.2% in Q2'11) and registered unemployment. At the same time, employment rate also decreased further, reaching historical lows of 41.9%. This resembles very much the pre-crisis situation on the labour market, featured by low rates of employment and unemployment and increasing number of emigrants (going up 3% in Q2'11). Thus, the economy is yet to start generating jobs on aggregate level as people have continued seeking job opportunities abroad. A deeper look into the data shows that industrial and service sectors are actually generating some new jobs, while agricultural sector is contracting, accounting for the overall decline in employment (Chart 3). The recovery of construction sector is also lagging behind, with few new orders for residential buildings and a consequent decrease in employment in the sector already for three quarters in a row.

The evolution of households' income, fairly reflected in households' consumption, has been on a positive track, and supported by various sources. Not only wages increased significantly (even when disregarding allowances in educational sector in June), but also the salary arrears were reduced. It is surprising though, that the most important rise in wages was in agricultural sector while the income from individual agricultural activities decreased on average in early 2011. Thus, while in 2010 a reduction of poverty rate in rural area became possible thanks to higher agricultural income, it seems that this year will be less favourable for the farmers, as not only income, but also costs of agricultural inputs increased. Therefore, it is not surprising that labour leaves the sector, a trend which will continue in mid-term.

PUBLIC FINANCE

The economic growth exceeded the most optimistic expectations but its effects have yet to show up in budgetary revenues. In the first seven months of 2011, the NBP's total revenues increased by 9.3% y-o-y, which is 98.5% (99.7% for fiscal revenues) of the expected level. The main drivers behind this performance are the low levels of excise revenues (91.6%) and revenues from the public institutions' special means (81.4%). This could jeopardize the expectations of increased excise revenues stemming from the increase in excise rates (tobacco, alcohol) in 2011. Though the VAT-related objectives were achieved, the receipts of VAT from goods and services produced in Moldova recorded the lowest level over the past six years (88.8% against the expected level and 94.4% y-o-y). The main explanation is the rising consumption of imported goods to the detriment of local products, and low ability to collect VAT on goods/services produced in the country. The low level of revenues collected from special road taxes (89% against expected level and 92% y-o-y) is also alarming, given the strategic importance of this sector, even despite the fact these taxes do not hold significant share in the total income.

Delays in expenditure execution - waste of revenues. The level of total expenditure execution (84.7% against expected level) is slightly below the average level recorded for the same period in the previous years (except for 2009). The sectors with the largest negative gaps in expenditure execution are agriculture and forestry (65.7%), environment protection (55.6%), transport and road management, communications and IT (57.1%), municipal and housing management (43%), fuel and energy complex (57.4%), other services related to economic activity (60.8%). The overall deficit in the period is also well below the expectations (39%), partly due to limited capacity of project implementation. Furthermore, implementation of projects under pressure at the end of the year leads to low effectiveness and efficiency of the implemented projects. Although this practice has existed for many years, so far there were no reliable tools found to correct this situation.

FINANCIAL SECTOR

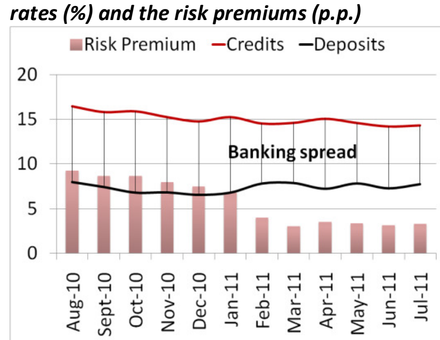
Despite the monetary policy tightening, credit expansion remained fully-fledged in the recent months. In July the interest rates remained close to historical lows (14.32%), while the amount of new loans in national currency increased by 21.1% y-o-y. The growth was relatively balanced between credits offered to households (+18.6%), mostly consumer loans, and credits contracted by businesses (+21.9%), mainly from trade / industrial sectors.

The banking system remains well capitalized and immune to various economic and non-economic shocks. On the one hand it undermines the monetary policy efficiency, as the commercial banks are net lenders, rather than borrowers to NBM; on the other hand, it ensures that the recent so-called "raider attacks" on the shareholders of several Moldovan banks will not have severe impact on the banking system stability.

The robust recovery in lending activity is determined by a two-fold effect of raising supply and demand for bank loans. The maturing economic recovery improved the financial situation of households and, respectively of businesses, which brightened their sector-specific and macroeconomic expectations. At the same time, the commercial banks decreased their spreads and risk premiums (Chart 4) in order to raise profits from the excessive cash accumulated during the "rainy days" of crisis.

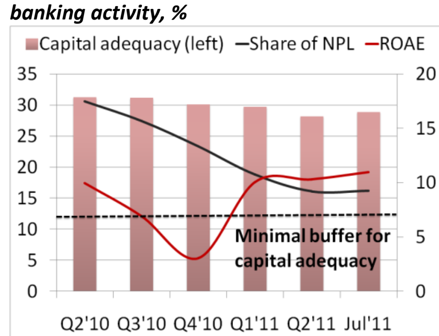
The financial situation in the banking system improved due to writing off bad loans and higher profits. Most of commercial banks were successful in fixing their balance sheets, by getting rid of bad loans, which fuelled the profitability levels (Chart 5). However, there are few relatively problematic banks, which are still struggling with high share of non-performing loans and are under the close supervision of NBM.

Chart 4. Bank' average lending and deposit rates (%) and the risk premiums (p.p.)



Source: NBM and EG calculations;

Chart 5. Key performance indicators of the banking activity, %



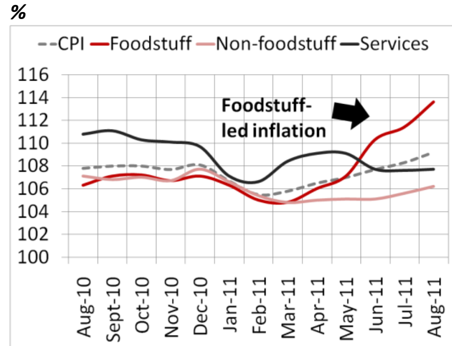
Source: NBM and EG calculations;

MONEY AND PRICES

In August, the monthly headline inflation (CPI) registered a mild slowdown (-0.1%), mainly due to seasonal factors. Summer-specific increase in the supply of fruits and vegetables made their prices to inch downward by 1% and, respectively 8.7%. These trends offset the price hikes for some socially important products, such as dairy products (+0.8%) and meat products (+1.1%). On the downside, the headline inflation was fuelled by raising international energy prices from July, which made the domestic prices for fuels to adjust (+2.3%) and spurred the growth of input costs for many producers and service providers (Chart 6).

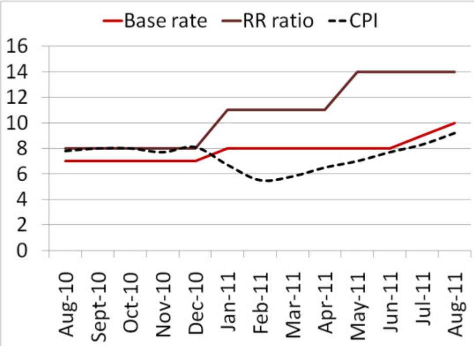
Some price hikes in several markets are determined by poor competition and systemic deficiencies of the national economy. Primarily, it is related to price increases for sugar and fuels, where the markets are highly concentrated and there is a high probability of cartel arrangements. It can partly explain the recent disputes between the „Bucuria„ confectionary company and its sugar supplier, as well as market shortages followed by price increase for liquid gas.

Chart 6. CPI and its main components, y-o-y, %



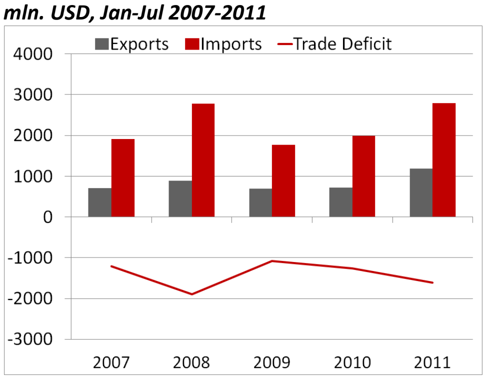
Source: NBM, NBS and EG calculations;

Chart 7. NBM base rate, requirement reserves ratio and y-o-y CPI, %



Source: NBM and NBS;

Chart 8. Evolution of Moldova foreign trade, mln. USD, Jan-Jul 2007-2011



Source: NBS and EG calculations;

The Central Bank continues its gradual monetary policy tightening in order to tackle the rising food and energy prices and domestic demand strengthening. The annual CPI significantly exceeded the NBM mid-term target on the grounds of strong cost-push combined with persistent demand-side inflationary pressures. Thus, on August 25 the central bank raised its base rate by 1 p.p. in order to ensure an efficient anchoring of inflationary expectations and keep the credit expansion under control (Chart 7).

FOREIGN TRADE

The exports are puffing along. In January-July 2011 the exports posted a stunning 63.1% y-o-y growth rate, making significant gains both in the EU and the CIS directions (Chart 8). In fact, in this period the exports expansion has appeared to be increasingly driven by demand from a relatively small group of countries: Russia, Romania, Italy, Germany, Ukraine and Poland, who together account for up to 70% of Moldovan exports.

The expansion of exports is continuously driven by two main trends. The first one is recovery in the "traditional sectors", such as textiles or metals, and the second factor is genuine growth in the new sectors, such as machinery (see more in MEGA no.4). However, in the case of both drivers the H2'2010 would represent a higher comparative base and it is reasonable to expect exports' growth rate to flatten towards the end of 2011. Thus, in mid- and long-term the growth of exports will hugely depend on the domestic structural reforms which have flattered to deceive ... to put it mildly (see also the Expert-Grup Short Analytic Note #57).

Imports are propped up by robust domestic demand and rising fuel prices. Consumption continues expanding at healthy rate fuelled by strong advances in inflow of remittances and real wages, but also by flagging saving rates (more on this see in Short Analytic Note #60). Furthermore, as situation on global commodity markets remains volatile with prices at historically high levels, Moldova has to face rising prices for its imports, both inputs and final products. Taken together, these two factors helped imports' growth rate achieve 40.2% mark. Since prices for natural gas are set to rise, while prices for other energy inputs may follow, this external factor will drag imports upwards further on, although consumption's expansion rates are expected to sag towards the end of the year.

STATISTICAL APPENDIX

TABLE 1. MOLDOVA: KEY SHORT-TERM ECONOMIC INDICATORS

	Nov'10	Dec'10	Jan'11	Feb'11	Mar'11	Apr'11	May'11	Jun'11	Jul'11	Aug'11
Industrial production growth rate, y-o-y, %	7.6	2.3	9.8	9.1.	3.7	11.4	4.9	11.6	7.8	n.a.
Retail-trade growth rate, y-o-y, %	12.7	9.2	21.1	17.4	18.4	18.8	22.8	24.2	n.a.	n.a.
Services to population growth rate, y-o-y, %	7.2	6.6	2.1	1.1	1.7	-6.5	-3.3	10.0	n.a.	n.a.
Merchandise exports, million USD	204.8	186.9	134.5	161.2	182.9	175.9	173.6	172.5	181.0	n.a.
Merchandise imports, million USD	405.4	439.9	284.8	356.9.	457.5	421.1.	437.6	417.5	414.8	n.a.
Official reserve assets, million USD	1610.9	1717.7	1744.5	1739.8	1793.4.	1918.4	1909.4	1901.5	1988.1	2018.9
Registered unemployed, persons, end-period	39943	40719	44170	50095	51204	48686	44719	41141	39146	37397
Real wage growth rate, y-o-y, %	2.8	-1.0	2.3	5.4	2.2	6.8	5.5	11.4	2.5	n.a.
Budget revenues growth rate, cumul. y-o-y, %	14.6	18.5	21	13.2	9.7	5.3	7.9	10.1	9.3	n.a.
Consumer prices growth rate, y-o-y, %	7.7	8.1	6.7	5.5	5.8	6.5	7.0	7.7	8.3	9.2
Nominal exchange rate, end-period, MDL/USD	12.12	12.15	11.98	11.99	11.90	11.69	11.67	11.61	11.40	11.34
Nominal exchange rate, end-period, MDL/EUR	15.96	16.10	16.44	16.53	16.82	16.87	16.60	16.75	16.30	16.37
Broad money (M2) growth rate, y-o-y, %	25.47	18.36	17.33	19.97	17.38	20.51	22.1	21.1	20.4	n.a.
Central bank refinancing rate, end-period, %	7.0	7.0	8.0	8.0	8.0	8.0	8.0	8.0	9.0	10.0
Bank deposit rate, %	6.82	6.54	6.79	7.82	6.79	7.23	7.83	7.28	7.75	n.a.
Bank lending rate, %	15.24	14.76	15.24	14.53	14.6.	15.05	14.59	14.20	14.32	n.a.
Banks liquid assets, % of total assets	33.36	34.15	34.62	n.a.	33.2	32.82	33.34	31.77	32.30	n.a.
Banks non-performent credits, % of total credits	14.80	13.33	13.39	n.a.	10.73	10.55	10.19	9.20	9.27	n.a.
Currency deposits, % of total deposits	47.92	48.45	48.55	n.a.	47.98	48.30	47.20	47.64	46.84	n.a.

Source: NBS, NBM and EG calculations and estimates;

TABLE 2. MOLDOVA: KEY LONG-TERM ECONOMIC INDICATORS

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Population, million (excludes Transnistria), end year	3.628	3.618	3.607	3.600	3.590	3.581	3.573	3.568	3.563
GDP, billion USD, current prices	1.662	1.981	2.598	2.988	3.408	4.401	6.055	5.403	5810
GDP per capita, USD at PPP	1761	1923	2126	2359	2559	2720	3004	2839	3088
GDP growth rate, y-o-y, %	7.8	6.6	7.4	7.5	4.8	3.0	7.2	-6.5	6.9
Private consumption growth rate, y-o-y, %	5.9	18.5	6.2	10.1	7.0	3.6	4.5	-7.9	9.0
Gross fixed capital formation growth rate, y-o-y, %	1.1	19.2	11.0	17.7	2.8	10.5	-7.8	-37.2	17.2
Industrial production growth rate, y-o-y, %	10,8	15.6	8.2	7,0	-4.8	-1.3	0.7	-22.2	7.0
Agricultural production growth rate, y-o-y, %	3.4	-13.6	20.8	0.8	-1.1	-23.1	32.1	-9.9	7.9
Share of industry in GDP, %	20.2	20.5	20.5	19.1	18.0	19.1	13.9	13.0	13.3
Share of agriculture in GDP, %	21.0	18.3	17.5	16.4	14.8	10.0	8.8	8.5	12.0
Merchandise exports, million USD	659.7	805.1	994.1	1104.6	1060.8	1373.3	1646.0	1321.5	1582.1
Merchandise imports, million USD	1037.5	1428.1	1748.2	2296.1	2644.4	3676.4	4866.3	3333.0	3855.3
Service exports, million USD	216.65	249.93	332.08	398.94	465.66	625.08	837.2	677.7	689.79
Service imports, million USD	256.99	294.26	353.05	419.68	487.64	631.16	824.72	701.8	770.10
Net foreign direct investment, million USD	83.6	73.64	147.8	190.86	234.16	522.04	691.49	112.0	198.9
Net work remittances, million USD	286.3	440.2	659.5	868.8	1119.0	1419.4	1795.8	1106.8	1253.3
Current account/GDP, %	-4.0	-6.6	-2.2	-8.1	-11.7	-15.2	-16.7	-8.6	-8.3
Official reserve assets, end-year, million USD	268.87	302.27	470.27	597.44	775.3	1333.7	1672.4	1480.3	1717.7
Total external debt stock, million USD	1816.5	1929.4	1881.8	2078.1	2528.9	3355.9	4106.1	4368.8	4618.1e
External debt/GDP, %	109.3	97.5	72.5	69.6	74.3	76.3	67.9	80.8	82.2
External debt/exports of goods and services, %	198.2	182.2	141.5	138.0	164.8	167.4	164.6	215.1	205.9
Employment rate, % of population aged above 15	53.3	47.5	45.7	45.4	42.9	42.5	42.5	42.8	38.5
Unemployment rate, % of economically active population	6.8	7.9	8.1	7.3	7.4	5.1	4.0	6.4	7.5
Real wage growth rate, y-o-y, %	20.9	15.4	10.1	6.8	14.2	8.0	10.2	9.0	0.7
Consumer prices, year average, %	5.2	11.6	12.5	12.0	12.8	12.4	12.8	0.0	7.4
General government balance, % of GDP	-2.2	1.0	0.4	1.5	-0.3	-0.3	-1.0	-7.0	-2.5
General government expenditure, % of GDP	31.5	33.1	35.1	37.0	40.1	41.8	41.6	43.5	40.8
Exchange rate, year average, MDL per USD	13.6	13.9	12.3	12.6	13.1	12.1	10.4	11.1	12.4
Broad money (M2) growth rate, y-o-y, %	30.4	24.4	44.8	36.7	12.2	47.3	18.3	-3.8	18.4
Central bank refinancing rate, end-year, %	9.5	14.0	14.5	12.5	14.5	16.0	14.0	5.0	7.0
Total commercial bank loans, % of GDP	27.9	28.5	30.3	30.2	33.6	40.2	39.8	41.4	37.2
Bank deposit rate, average per period, %	14.4	12.7	15.2	13.0	11.9	15.1	18.1	14.7	7.56
Bank lending rate, average per period,%	23.1	19.2	21.0	18.9	18.2	18.9	21.0	20.3	16.25

Source: NBS, IMF, NBM and EG calculations and estimates;